

CEPS COMMENTARY



Thinking ahead for Europe

The False Promise of a Eurozone Budget

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A key question confronts the four presidents of Europe's major institutions –the European Commission, the European Council, the European Central Bank and the Eurogroup, the informal gathering of Finance Ministers of the countries that share the euro – as they prepare their report on how to reform the common currency: Does the eurozone need its own budget?

They are facing the argument that the United States' monetary union works much better because there is a large federal budget to smooth the impact of asymmetric shocks – that is, shocks to individual states. The eurozone, it is claimed, should have its own budget to provide similarly automatic insurance to its members.

This argument, however, misreads the US experience.

True, in the US, as in most existing federal states, the federal budget redistributes income across regions, thus offsetting at least part of the interregional differences in income. But, while this has been repeatedly documented in many cases, the inference that redistribution is equivalent to a shock absorber is wrong.

For example in the US, the federal budget offsets a substantial part (estimated at 30-40%) of the differences in *per capita* income levels across states, because poorer states contribute less income tax, on average, and receive higher transfer payments. But this does not imply that these mechanisms also provide insurance against shocks (sudden changes in income for individual states). Many of the transfers from the federal government, especially basic social support like food stamps – vary little with the local business cycle.

On the revenue side, the degree to which federal taxation absorbs shocks at the state level cannot be very large for the simple reason that the main source of federal revenues that does react to the business cycle, the federal income tax, accounts for less than 10% of GDP.

The low sensitivity of both federal expenditure and federal revenues to local business-cycle conditions explains why only a small fraction (estimated at about 10-15%) of any shock to the GDP of any individual state is absorbed via automatic transfers to and from the US federal budget.

One idea that has been mooted repeatedly in Europe is to create some European, or at least eurozone, unemployment insurance fund. This idea is attractive at first sight. But here, too, the reference to the US experience is misleading.

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In the US, unemployment insurance is organised at the state level. The federal government intervenes only in the case of major nationwide recessions and provides some supplementary benefits for the long-term employed. But this support is given to all states and thus does not provide those most affected with much more support than the others receive.

Moreover, unemployment benefits are not as important as is often assumed. In most countries, they amount to only about 2-3% of GDP, even during a major recession. In the US, the annual supplementary federal expenditure amounted to only about 1% of GDP in recent years. It is thus clear that a eurozone unemployment insurance system would never be able to offset major shocks, such as those hitting Ireland or Greece, where GDP has shrunk by more than 10%.

The case of Spain illustrates another feature of European economies that makes it difficult to argue for a federal unemployment scheme. Spanish unemployment is now close to 30%, which *a priori* should be a good justification for some form of shock absorber. But Spanish unemployment has in fact been consistently higher than the eurozone average, and fell to single-digit levels only as a result of an unsustainable building boom. Any common eurozone unemployment scheme would thus risk financing the long-term unemployment created by rigid national labour-market institutions, which for decades have proved impervious to reforms.

All in all, it is difficult to base the argument for some eurozone shock absorber on the US experience. But how can one explain the fact that the global financial crisis led to no regional banking crises in the US, whereas several eurozone countries' banking systems are under such stress that their governments have had to rescue them (and then be rescued in turn by the eurozone's bailout fund)?

This reflects another aspect of US arrangements that, again, is not widely appreciated. The US 'banking union' provides tangible insurance against local financial shocks. For example, the local real-estate boom and bust in Nevada was as severe as that in Spain or Ireland. But, in Nevada, which is similar in size to Ireland, the local banking system's losses were absorbed to a large extent by US "banking union" institutions, particularly the Federal Deposit Insurance Corporation (FDIC) and the federal mortgage-refinancing agencies, Fannie Mae and Freddie Mac.

For Nevada, such support can be estimated at 10-20% of its "national" income. Ireland would certainly be in much better shape if it had received a similar transfer.

This leads to a simple conclusion: The euro's long-term stability depends far more on completing plans for a European banking union than it does on creating some new budget for the eurozone.